

Ignore financial market myths for a sound investment strategy

Financial myths often are used to get attention, promote an agenda or win business — but they don't achieve investor peace of mind.

The last decade was one of the worst periods in history for the U.S. financial markets — and one of the best opportunities for promoting financial falsehoods.

Here are some of the most egregious fiscal myths still floating around and why you should ignore them:

• **Myth One:** “Capitalism is dead.” There's a common myth that the U.S. is heading into a socialistic environment under the current administration.

But if you study American history, during times of great economic turmoil, the government has stepped in and acquired assets for short periods of time and then re-privatized them.

In 1984, under Ronald Reagan's Republican administration, the nation's seventh largest bank, Continental Illinois National Bank, was taken over by the government and not re-privatized until 1994 (under a Democratic administration) when Bank of America acquired it.

• **Myth Two:** “Diversification is dead.” In the recent bear market, all asset classes declined in unison, from small cap or large cap investments to international markets. Although everyone lost money regardless of portfolio diversification, the pundits spun this into the mantra that “diversification no longer works.”

The contrary is true: Since March 9 of last year, globally diversified portfolios were up roughly 97 percent while the general market grew only 77 percent. Although diversification doesn't



Guest Column

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always insulate a portfolio, both historically and during the most recent market advance, diversified portfolios have produced higher risk-adjusted returns.

• **Myth Three:** “Look at mutual funds' past performance to determine future performance.” This represents one of the emotional biases in investing. There's no statistical evidence to support the fact that historical out-performance is indicative of future out-performance. More likely, the reason for recent out-performance was an increased weighting in a specific industry — such as tech stocks in the late '90s or more recently homebuilding. When those sectors invariably correct, the fund may likely underperform. Who cares what a fund has done in the past five years? Instead, be concerned about what it does during the next five to 10 years. Don't rely solely on historical results. Focus on the more controllable aspects of investing, such as limiting expenses, adequate diversification and, perhaps most important of all, patience.

• **Myth Four:** “You can time the market.” Most financial gurus advocate the active investment management ap-

proach, which says you can beat the market through security selection and/or market timing — essentially relying on the financial manager's ability to predict the future.

Conversely, the passive portfolio management approach, based on extensive academic research, embraces capitalism and relies on the concept of market efficiency. This philosophy postulates that market timing doesn't work — nor does the ability to consistently pick outperforming stocks and bonds. In the end, market timing adds uncertainty, reduces efficiency and increases taxes and costs.

• **Myth Five:** “You can be a successful investor without assuming any risk.” Risk is inherent in life, and investing is no different. Some fund management firms will promote products that claim to limit risk and still generate market returns. Sound too good to be true? It is. There's a normative relationship between risk and return that can't be ignored. You can mitigate risk through effective diversification and allocation — but you can't avoid it. Risk tolerance is both economic and psychological. You must assess your tolerance and assume risk intelligently — not on a speculative level.

• **Myth Six:** “Your portfolio should be allocated based on age.” Some financial advisers pigeon-hole investors into a moderate or aggressive growth portfolio based on how old they are. Advisers also might use questionable rules, like subtracting your current age from 100, which determines the percentage

of investments you should allocate to equities. This “one-size-fits-all” approach is ill-advised because it doesn't take into consideration risk tolerance or where you are in relation to your savings goals. If your portfolio structure isn't in line with your risk tolerance, you won't remain invested through difficult markets, which ultimately will sabotage any chance of success.

• **Myth Seven:** “All investment providers are subject to the same standard of care.” Most financial advisers are bound by a “suitability” standard — meaning they only have to recommend an investment that fits your situation. Under this standard, a financial adviser still could win an incentive prize to Maui or a flat-screen TV for selling you a particular “suitable” investment. The line is blurred between functioning as a fiduciary and almost functioning in a fiduciary capacity. An adviser operating under a fiduciary standard is required to put the interests of the client first.

Remember: Financial decisions based on clichés, punditry and market spin are dangerous for investment decision-making. Empower yourself with a prudent investment philosophy, and you will discover that, while myths make excellent sound bites, they don't provide a sound investment strategy.

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